

NAB's Response to the Financial System Inquiry's Interim Report



more give, less take

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I. Summary of Recommendations

Systemic Stability

- Australia should not adopt a bail-in regime for senior bank creditors, as this would not be consistent with the goal of ensuring systemic stability.
- A preferred alternative to senior creditor bail-in would be for Australian banks to hold higher levels of Total Capital, which could be met with non-equity capital instruments in the form of additional Tier 1 or Tier 2 loss absorbing capital.
- Ring-fencing the activities of Australian ADIs is not required.

Capital Ratios

- Consideration should be given to harmonising the calculation of capital ratios alongside the Basel Committee's minimum recommendations.
- The Inquiry should undertake further analysis on Australian bank capital ratios.

Standardised and IRB Risk Weights

- No changes should be made to current arrangements for standardised and IRB risk weightings.

Superannuation

- The *MySuper* regime and its early impact on fee compression should continue to be monitored. Until the effectiveness of the *MySuper* regime can be assessed and reviewed, there should be no change to current arrangements.
- NAB does not support the proposed default auction process, as this will not improve retirement outcomes for members.
- NAB promotes full and open competition for default superannuation as a means of improving member outcomes and recommends that any remaining impediments that constrain employers from being able to nominate any *MySuper* product as their default superannuation fund be removed.
- Fund portability should be extended to between 14 and 30 days, so that the need for trustees to apply for relief would arise only in the most extreme circumstances.

Retirement Products

- Encourage funds to focus disclosure and communication (including calculators) on how much members' savings will potentially produce as income replacement in retirement across a range of projected scenarios (poor, moderate or good outcomes).
- Remove impediments to, and consider incentives for, the development and adoption of income stream products or adjuncts which mitigate risks in retirement, including longevity risk.

Retirement Products (continued)

- Remove impediments to the use of online interactive tools which allow members to test and model different scenarios (with reasonable controls).
- Enable trustees to create 'default income stream' options in the context of their fund membership profile together with a fiduciary requirement to consider longevity, market and inflation risks.
- Consult further with industry on options to compare and assess income stream products.

Equity Release

- Further discussion and guidance is required regarding satisfying credit licensee requirements for equity release under NCCP, Responsible Lending and Unfair Contract Terms.
- Clarity around potential capital treatment of equity release products is required to understand economic implications for lenders.

Financial Advice

Education and competency standards:

- Minimum education standards should be raised and competency standards formalised.
- An enhanced register of financial advisers advising on Tier 1 products (or complex strategies) should be developed, including a designation of 'independent' only where applicable to both the adviser and their licensee under the legislated provisions. The register and/or SOAs could be enhanced to show shareholding or majority ownership of license.
- Establish a National Competency Board with professional associations and regulators represented on the Board. Sub-committees should have financial planner or licensee representation.
- Review ongoing education requirements under the auspices of a National Competency Board and existing professional bodies.
- 'Tier 1 Financial Advisers' should be required to have membership in an accredited and recognised professional body.
- The National Competency Board should develop a set of standards for minimum competency across the advice architecture model (excluding factual). NAB supports:
 - a) New entrant 'Tier 1 Financial Advisers' from 2018 providing personal advice or complex strategic advice to retail clients having a relevant tertiary qualification.
 - b) Existing planners being subject to a National Exam.
 - c) Specialist accreditation being required for SMSFs and other strategic advice areas such as Aged Care, Estate Planning and Business Succession (as specialist electives).

Financial Advice (continued)

Regulatory advice architecture:

- Consideration should be given to refining the regulatory advice architecture in the *Corporations Act* – currently based on product recommendations and segmented into factual information, general advice, and personal advice.

Vertically integrated models, independent and aligned advice:

- The customer experience with vertically integrated entities can be enhanced through: a) Refinement of existing disclosure, and; b) Improved governance models for licensees.

Rationalisation of Legacy Products

- Specific alteration to Financial Services and Taxation laws is required to allow product issuers to transfer customers to contemporary products.
- The successor fund transfer provisions could be supported by the development of an industry backed guide for Successor Fund Transfers, similar to the Unit Pricing Guide for Good Practice issued by APRA and ASIC in August 2008.

Payment Systems

- Interchange fee caps should be expanded to include payments of similar economic substance.
- Differences in interchange should be capped by retaining the existing weighted average fee and introducing both a floor and cap.
- Proposals that allow merchant choice and ensure that cardholders are the only party able to determine the routing of a transaction should be rejected.
- Schemes should be allowed to reintroduce the 'No Surcharge' rules.

The Role of Superannuation in Funding Australia's Growth

- APRA should introduce a new run-off category for superannuation deposits which has a 50% runoff rate assumption.

Domestic Bond Market

- The impact of the Simple Corporate Bond legislation should be reviewed, before any further changes are made to the issue of 'vanilla bonds' to retail investors.

Infrastructure Financing

- The development of external credit ratings should be encouraged to create risk visibility and/or minimum public financial disclosure (similar to that required under ASX listing rules), which address concerns around ensuring adequate public information for retail investors to understand project risks.

SME Access to Funding

- NAB supports the expansion of CCR to SME customers. However this will not automatically improve access to or costs of funding for SMEs, particularly for newly formed businesses, as CCR cannot replicate the role of the Client-Banker relationship.
- No additional restrictions should be placed on current SME loan structuring practices.
- NAB is supportive of further analysis and development of a regulatory framework that would aid in development of a domestic market for securitising SME loans.

Shared Value Initiatives

- Government should take an active role in establishing a market for financial products in Australia to support impact investment, including Social Impact Bonds and support for intermediary institutions and organisations that can act as a catalyst for the market's development.
- Fiduciary duties for trustees should be clarified, so that trustees are able to consider Impact Investment as part of their investment portfolio.
- Government should consider expanding its current level of support for Australia's microfinance sector, as it has proven to be effective at leveraging community and private sector capabilities.
- A long term funding commitment of five years or more is required to allow for the protection of the capital investment into these programs and the ongoing exploration of innovative solutions to enable scale and reach.
- NAB does not support the enforcement or regulation of mandatory programs at an industry level. We believe this will lead to broad brush and sub-standard solutions that will have little impact.

2. Introduction and Overview

National Australia Bank Ltd (NAB) appreciates the opportunity to make a second round submission to the Financial System Inquiry ('FSI' or 'the Inquiry').

As a member of the Australian Bankers Association (ABA), NAB continues to participate in the development of the ABA's response on behalf of the banking industry and as such, we are broadly supportive of the ABA's second round submission.

Changes recommended by this Inquiry must ensure that the strength and stability of the Australian financial system are maintained, whilst also delivering improved efficiency and fairness. Importantly, the Inquiry needs to address the challenges posed by the reliance of Australian financial intermediaries on offshore wholesale funding. These risks were exposed in the fourth quarter of 2008. Since then, the banking sector has made significant progress in reducing its use of short dated off-shore wholesale funding. Nevertheless, there remains an opportunity to further enhance the resilience of the system by accessing Australia's growing pool of superannuation savings. To address this, the Inquiry has to make judgements about the roles that should be played by both traditional financial intermediaries (banks) and superannuation funds in financing real investment, facilitating the accumulation of household savings and supporting macroeconomic stability. These roles are not independent.

In this regard, our submission addresses what we believe are the most critical issues for the Inquiry to resolve:

- **Systemic Stability:** For the Australian economy to continue to grow, Australia is likely to be a net importer of capital for the foreseeable future. Our financial institutions will need to continue to compete for capital in global markets. For Australian banks to secure funding, investors must have complete confidence in the strength of the Australian financial system. We believe that a senior creditor bail-in regime would not be consistent with ensuring systemic stability in Australia. A preferred alternative would be for Australian banks to have higher Total Capital levels, which could be met with non-equity capital instruments in the form of additional Tier 1 or Tier 2 loss absorbing capital. This would ensure greater stability and resilience throughout the economic cycle.
- **Capital Ratios:** Calculation of Australian banks' capital ratios should be harmonised with international standards, which would allow Australian banks to more accurately be compared to their international peers. Any increase in Total Capital levels that may be considered necessary to enhance systemic stability should be considered in conjunction with capital ratios calculated on a harmonised basis.
- **Superannuation: Stronger Super** initiatives have already delivered benefits and fee compression for consumers and will continue to do so. Policy makers should not be focused on fees alone, but must aim to improve overall 'outcomes' for retirees. NAB supports the continued development of innovative retirement solutions that allow Australians to manage their retirement needs, particularly by addressing longevity risk.
- **Funding the economy:** In recent years, banks have played a major role in funding Australia's economic growth. In the years ahead, more diversified funding sources can be made available. Specifically, NAB supports the development of deeper and more liquid domestic bond and securitisation markets, increased infrastructure financing and greater shared value initiatives. We also believe that superannuation can play a greater role in funding Australia's growth via the banking system, than is currently the case.

In addition to the above, this submission also makes recommendations in several other key policy areas under consideration by the Inquiry.

3. Systemic Stability

A systemically important financial institution is one that, by definition, would render the entire financial system unstable, were it unable to meet its creditor obligations, on time or in full. Thus, ensuring systemic stability requires that all systemically important financial institutions never become insolvent. Some believe that this results in an implicit guarantee of the solvency of systemically important financial institutions, which introduces moral hazard. This is a concern because it could mean that underlying commercial risks are mispriced.

To address this risk, the Interim Report proposes that consideration be given to sovereign-imposed creditor bail-ins in some circumstances. Bail-ins have two components: a haircut and a standstill. Both of these would also trigger systemic instability in particular circumstances. While a creditor haircut might save a financial institution from insolvency, in the absence of an effective standstill, the institution would rapidly become illiquid, as creditors redeemed their funds and withdrew from the Australian market. Even the prospect of the Australian Government being prepared to impose restrictions on capital mobility, of any sort, would be reflected in a sovereign risk premium on all funds accessed by all Australian borrowers and, in extreme cases, could result in a currency crisis.

Concern about the risk of moral hazard should be tempered by recognition of:

- 1) The role of the RBA in monitoring emerging sources of systemic risk;
- 2) The quality of prudential regulation applied to Australian banks, and;
- 3) The fact that systemic stability does not require that shareholders, other providers of loss absorbing capital, management or boards are protected from loss.

The essential attributes of a stable banking system:

Credit, liquidity and maturity transformation that are the essence of the credit intermediation process, means that no bank or banking system, irrespective of its size or balance sheet strength, can meet the demands of all of its funding providers, should repayment of those funds be demanded immediately. Backstops are necessary to ensure stability.

In NAB's view, the essential attributes of a sound financial system, which are currently in place in Australia, are as follows:

- 1) A strong prudential regulator that closely monitors the activities of its regulated Authorised Deposit-taking Institutions (ADIs) to ensure that risk taking is not excessive;

- 2) Well capitalised and conservatively managed institutions with strong risk management frameworks and which aim to maintain strong credit ratings;
- 3) A strong and credible central bank that can offer liquidity support when required;
- 4) Temporary and targeted Federal government intervention in the financial system in extreme circumstances, such as the GFC;
- 5) The ability of regulators to identify and manage potential sources of systemic risk, before they become so large as to threaten the system, and;
- 6) A relatively small shadow banking sector.

It is the combination of these factors that determines the strength of the system overall.

The objective of the above is to ensure that at all times funding providers remain confident that any Australian ADI is a safe place for their funds to be invested, and remains so during periods of extreme market stress.

Australia's approach to systemic stability and the avoidance of economically costly banking crises is widely known. Moody's describes the approach to financial system regulation in the APEC region (including Australia) as follows:¹

"The emphasis has typically been on crisis prevention through sound supervision and macro prudential measures, along with stringent capital and liquidity requirements, consistent with Basel III. Regulators in much of the region view the least costly way of addressing banking sector stress, in terms of collateral economic damage and weakening of public finances, as taking early action when stress arises, rather than waiting for resolution and bail-in regimes to be triggered."

Not 'Too Big To Fail', but 'Too Critical To Ignore'

In the Australian context, 'Too Big To Fail' (TBTF) relates to the perception that each of the big four Australian Banks (ANZ, CBA, NAB and WBC) is so large, relative to the Australian financial system and the economy overall, that government support would be provided, in one form or other, to prevent the failure of these institutions to meet their creditor obligations, but this same level of support would not be forthcoming for other Australian ADIs.

It has been argued that this creates a competitive disadvantage for those institutions that are not deemed to be TBTF, as they have a higher relative cost of funds. It is also argued that this 'implicit guarantee' puts taxpayer funds at risk and, if ever exercised, would adversely impact the solvency of the sovereign.

¹ Moody's Investor Service, "A Compendium of Bank Resolution and Bail-In Regimes in the Asia-Pacific", 24 July 2014.

Maintaining investor trust (depositors and creditors) in all Australian ADIs is crucial to ensuring systemic stability. The way creditors in all Australian banks, including smaller ADIs, are treated, is central to Australia maintaining its global reputation as being committed to financial system stability. For this reason, every Australian ADI is of systemic importance, particularly in a crisis. So rather than just four institutions being 'Too Big To Fail', the reality is that all Australian ADIs are '**Too Critical To Ignore**'.

This was the philosophy adopted by Australian regulators and the Commonwealth Government in 2008, which saw temporary and targeted support to stabilise the Australian financial system via:

- Allowing all ADIs to use the Commonwealth Government's credit rating to support their borrowings in return for a fee;
- A guarantee on deposits up to \$1m (later reduced to \$250,000 under the *Financial Claims Scheme*);
- Support for RMBS markets via the Australian Office of Financial Management (AOFM), and;
- Liquidity support provided to the system by the RBA.

The practical effect of these measures was that roll-over risk for the banking system was reduced significantly, which gave banks the confidence to keep lending to support the economy. Funding support continued to be available to all Australian ADIs, which allowed time for an orderly response to the stresses caused by the GFC. Despite the most severe global financial disruption since the 1930s, no Australian bank failed to meet its obligations to creditors.

In the absence of these measures, the alternative would have been very different:

- It is likely that some Australian ADIs would have failed;
- Losses would have been incurred on the liquid asset holdings of other banks, leading to a weakening of their balance sheets. Given the shortage of government debt securities in Australia, there is a high degree of connectedness between Australian banks, as bank paper constitutes a higher proportion of liquid asset holdings than is the case in most other jurisdictions;
- The reduction in investor confidence that would have spread to the remaining ADIs would have meant that all Australian banks would have had greater difficulty accessing wholesale funding markets;
- The contraction in credit would have seen asset values decline;

- Falling asset values would have exacerbated the balance sheet stresses that Australian ADI's were already experiencing, thereby compounding the stress, and;
- A materially adverse impact on the sovereign balance sheet would have eventuated, through lower (possibly negative) GDP growth, lower taxes, and higher unemployment benefits.

Moral hazard is not a compelling argument for bailing-in senior creditors

Those that believe senior creditors should also suffer losses when a bank fails argue that without this market discipline, banks are encouraged to take excessive risk, as capital is under-priced. This 'moral hazard' argument ignores the fact that funding cost is not the key determinant of institutional risk taking. Over an economic cycle the nexus between risk and bank funding costs is weak.

The history of banking crises shows that the risks which eventually threaten a financial system do not suddenly appear overnight, but rather, they accumulate gradually over time. It is only when economic conditions deteriorate, that these risks become fully apparent to the market and are repriced by funding providers, by which time it is too late to remove these risk from banks' balance sheets.

Unless creditors have confidence that their funds will be repaid in full and on time, they will withdraw support. Roll-over risk escalates and the probability of failure increases exponentially.

Two main problems arise from the adoption of a senior creditor bail-in regime

Calls for countries to adopt a bail-in regime for senior creditors are a response to the overseas experience from the GFC. A combination of weak regulation, undercapitalised and over leveraged banks, and excessive risk taking resulted in a number of large financial institutions needing direct government financial support, in order to prevent their collapse. This saw sovereign balance sheets of many countries overwhelmed by the debts of their banking systems. This was not the experience in Australia.

NAB sees two main risks if Australia were to adopt a bail-in regime for senior creditors:

1. Negative rating implications

The four major Australian banks are amongst the most highly rated banks in the world, rated AA- and Aa2 by Standard & Poor's (S&P) and Moody's respectively. As such, they enjoy strong investor support. This on-going support is critical for a small and open economy such as Australia, running a current account deficit which is funded via the banking system.

Adoption by Australia of a senior creditor bail-in regime is likely to have negative ratings implications for Australian banks, as several recent examples demonstrate:

- On 11 June 2014, Moody’s Investor Service revised its outlook on Canada’s seven largest banks from stable to negative.² Its decision was based on comments by the Central Bank of Canada in March 2013 that a bail-in regime would exist for senior debt holders and uninsured depositors, if a bank failed. This led Moody’s to revise its assumptions around the level of systemic support Canadian banks would receive in a crisis. S&P followed on 8 August, 2014, revising its outlook on six Canadian banks to ‘negative’, following its review of Canada’s bail-in proposals.³
- On 5 August 2014, Moody’s revised its outlook for the UK banking system from ‘stable’ to ‘negative’, due to the reduction in systemic support that is likely to flow from the UK government’s finalisation of creditor bail-in legislation and ring fencing. Moody’s view is that:

“This change [from stable to negative outlook] reflects our view that the improved operating environment and banks’ stable financial fundamentals will not fully offset the negative credit implications of the finalisation of the UK resolution and bail-in regime and the related ‘ring-fencing’ framework.”⁴

A ratings downgrade for Australian banks would likely result in an increase in funding costs and reduced access to offshore wholesale markets, both of which would adversely impact Australia’s GDP growth.

2. Second order costs to the taxpayer of not preventing failures

For those who advocate creditor bail-in, its appeal lies in the belief that by ensuring losses of a failed financial institution (over and above losses absorbed by shareholders) are carried entirely by creditors, taxpayer funds will never be at risk. ‘First order losses’ for the taxpayer are supposedly avoided. In NAB’s view, this argument ignores two critical points:

- Under senior creditor bail-in, first order losses are unlikely to be confined to just one institution:
 - Banking crises are rarely idiosyncratic – they are almost always systemic.
 - In a deep systemic crisis, bail-in provisions exacerbate rollover risk, as creditors, fearing bail-in, will do the economically rational thing – they will withdraw support, thereby increasing the risk that the institution will fail.

- As the weakest institution in a financial system fails, contagion spreads. Liquidity evaporates from the system overall, leading to a chain of disorderly collapses. This is the essence of a systemic banking crisis.
- Advocates of senior creditor bail-in also overlook the ‘second order impact’ which arises from the damage that a financial crisis does to the real economy:
 - An analysis of the resolution of banking crises by International Monetary Fund (IMF) examined the cost (as a percentage of GDP) of banking crises using three metrics. It found that the cost of the 2007-09 banking crisis in the 13 countries examined was 4.9% in direct fiscal costs, 23.9% increase in public sector debt, and 24.5% output loss.⁵

Table 1: Summary of the Cost of Banking Crises
(Over the period 1970 – 2009)

	Direct Fiscal Cost	Increase in Public Debt	Output Losses
Medians (% of GDP)			
Old crises (1970-2006):			
Advanced Economies	3.7%	36.2%	32.9%
Emerging Markets	11.5%	12.7%	29.4%
All	10.0%	16.3%	19.5%
New crises (2007-2009):			
Advanced Economies	5.9%	25.1%	24.8%
Emerging Markets	4.8%	23.9%	4.7%
All	4.9%	23.9%	24.5%

SOURCE: IMF Working Paper WP/10/146

- More recent analysis by the Federal Reserve Bank of Dallas quantified the financial impact of the US financial crisis of 2007 to 2009. The report concluded that the US crisis conservatively cost 40-90% of one year’s output, equivalent to US\$6-14tr, or US\$50,000 to \$120,000 per US household. When other measures of lost consumption were included, the report concluded that it was likely that the cost of the crisis was greater than one year’s output.⁶

In NAB’s view, senior creditor bail-in is not conducive to a stable financial system, particularly in times of crisis. It is a reactive solution that addresses the cost of failure once a bank’s loss absorbing capital base is depleted.

² Moody’s Investor Service, “Canadian Banks: Outlook Negative”, 11 June 2014.

³ Standard & Poor’s Rating Services, Rating Actions, 8 August, 2014.

⁴ Moody’s Investors Service, “Banking System Outlook: United Kingdom”, 5 August, 2014.

⁵ IMF Working Paper WP/10/146, “Resolution of banking Crises, The Good, the Bad, and the Ugly”, L. Laeven and F. Valencia, June 2010.

⁶ T. Atkinson, D. Luttrell and H. Rosenblum, “How Bad Was It? The Costs and Consequences of the 2007-09 Financial Crisis”, Federal Reserve Bank of Dallas, Staff Papers, 20 July 2013.

Whilst superficially it appears to offer the benefit of no direct taxpayer support for a failing institution, it is likely to exacerbate the crisis and increase the ultimate cost to the economy and to the sovereign. In a systemic crisis, the loss of funding support is unlikely to be contained to just one institution.

An alternative to senior creditor bail-in

The success of the current regulatory framework has resulted in Australia being acknowledged as having one of the safest and most stable financial systems in the world. In NAB's view, the regulatory focus should continue to be on 'prevention' rather than a 'cure' – financial system regulation should continue to be designed to reduce to an absolute minimum the probability that an Australian ADI will be unable to meet its creditor obligations, rather than be focused on who will pay in the event that losses exceed an institution's loss absorbing capital levels. Senior creditor bail-in is not consistent with this objective.

The debate around the pros and cons of creditor bail-in regimes is continuing and views differ across jurisdictions as to its merit and design. The Financial Stability Board (FSB) has required that a formalised bail-in regime is necessary only at the G-SIB level.⁷ The FSB has left it to local regulators to determine whether or not bail-in is also suitable for domestic banks within each system.⁸ Those jurisdictions that have opted for creditor bail-in frameworks will not be implemented until January 2015.

As an alternative to senior creditor bail-in, consideration could be given to requiring banks to hold additional levels of loss absorbing capital, the quantum of which would depend upon the size of the institution. If this option is adopted, the preferred solution would be an increase in Total Capital levels, which could be met with non-equity capital instruments, such as additional Tier 1 capital (which is expected to contribute to leverage ratio requirements) or Tier 2 capital. This would have the effect of further protecting senior creditors, but would have a lower cost to the banking industry than additional common equity.

It is impossible to predict in advance what the nature and shape of the next financial crisis will be, or how it should be managed at that time. What is critical in any crisis is

ensuring that liquidity support for institutions is maintained and that roll-over risk is reduced to a minimum. A creditor bail-in scheme applied arbitrarily to funding providers would prove counter-productive in restoring an ADI to health in times of crisis.

Little benefit from ring-fencing

Ring-fencing aims to reduce the likelihood of failure of certain parts of a regulated institution, by legally separating other parts of the institution that are deemed to be higher risk. It is a complex and costly exercise. NAB does not believe that ring fencing the activities of Australia ADI's is warranted, for two reasons:

- 1) APRA already has power to direct that certain activities of an ADI be restricted (in whole or in part) via its directions powers under the Banking Act (1959), as well as its prudential framework. Furthermore, the proposed Level 3 conglomerate framework will give additional powers to the prudential regulator for the supervision of conglomerate groups.⁹ Ring fencing does not materially add to these powers.
- 2) The elimination of certain activities from the operations of a regulated institution may make that institution safer, but it will do little to improve the safety of the financial system overall. Imposing excessive restrictions on the activities of regulated banks results in those activities migrating to the shadow banking sector, beyond the view of the prudential regulator. Australia enjoys the advantage of having a relatively small shadow banking sector. As noted in the RBA's submission to the FSI, non-prudentially regulated assets account for only around 10% of financial system assets in Australia, which is low by international standards.¹⁰ In NAB's view, this is one of the reasons that the Australian financial system has proven to be so resilient.

In short, although ring-fencing reduces idiosyncratic risk, it potentially comes at the cost of increasing systemic risk.

Recommendations:

- Australia should not adopt a bail-in regime for senior bank creditors, as this would not be consistent with the goal of ensuring systemic stability.
- A preferred alternative to senior creditor bail-in would be for Australian banks to hold higher levels of Total Capital, which could be met with non-equity capital instruments in the form of additional Tier 1 or Tier 2 loss absorbing capital.
- Ring-fencing the activities of Australian ADIs is not required.

⁷ G-SIBs are Global Systemically Important Banks.

⁸ Financial Stability Board, "Effective Resolution of SIFIs: Recommendations and Timelines", 17 July, 2011 and "Progress and Next Steps Towards Ending TBTF", 2 September 2013.

⁹ Australian Prudential Regulation Authority (APRA), "Response to Submissions, Supervision of conglomerate groups, 3. Prudential standards and draft guidance", August, 2014.

¹⁰ Reserve Bank of Australia, "Submission to the FSI", March 2014, p.157, quoting research by C. Schwartz and T. Carr, "Shadow Banking: Australian and International Experience Around Times of Financial Stress and Regulatory Reform", JASSA, The Finsia Journal of Applied Finance, Issue 3, p.30-38.

4. Capital Ratios

NAB notes the Inquiry's observations that the capital ratios of Australian banks are:

"...around the middle of the range relative to other countries".¹¹

and that:

"In fact, banks' capital ratios do not appear excessively high, including when compared to countries at a similar level of financial development".¹²

The Interim Report illustrates this within Chart 5.3, which notes that it is *"Calculated on a consistent basis by the BCBS"*, and suggests that Australian banks have capital levels that are below the median of their global peer group.

NAB disagrees with the conclusions the Inquiry has reached on this issue.

The statement that the positions are *"Calculated on a consistent basis across countries by the BCBS"* is not correct. The BCBS data was aggregated after a recent Basel III quantitative impact study (QIS). There are a number of areas where the QIS differs from the BCBS harmonised capital position, after following the instructions from our prudential regulator, APRA, when completing the QIS. For example, our QIS data for our Common Equity Tier 1 position had two key material differences to the BCBS harmonised position:

- 1) It recognised risk weighted assets held for Interest Rate Risk in the Banking Book, and;
- 2) It recognised the higher risk weighted assets that result from the higher loss given default floor for residential mortgages.

In total, these two items equate to approximately 1.06% of CET1 capital. To give another perspective, NAB's CET1 capital (calculated on an APRA basis) was 8.64% at March 2014, with that increasing to 10.46% when material harmonised adjustments are made (as per NAB's 2014 Half Year Results Investor Presentation released 8 May 2014).

In addition, this example illustrates the difficulty in comparing bank capital levels across different jurisdictions, following the implementation of specific national differences.

Alongside these two items listed above, there are a number of differences (both positive and negative to capital) that impact NAB's fully harmonised capital position. We refer the Inquiry to analysis which Pricewaterhouse Coopers (PwC) has been commissioned to undertake on behalf of the ABA, which addresses this issue more fully. The PwC report highlights the impact of the risk appetite and portfolio composition of each of the major banks. Those banks that focused on retail lending receive a greater advantage from the harmonised adjustments.

Recommendations:

- Consideration should be given to harmonising the calculation of capital ratios alongside the Basel Committee's minimum recommendations.
- The Inquiry should undertake further analysis on Australian bank capital ratios.

5. Standardised and IRB Risk Weights

Difference in risk weights is less than claimed

Intervening in the risk weights applied to mortgages involves a trade-off between competition and financial stability. NAB believes that the competitive disadvantage argued by ADIs using the standardised approach is less than the headline numbers would suggest, once the data is presented in a comparable form.

APRA's FSI submission notes that while average risk weights for IRB mortgages are 18% compared to 39% for standardised mortgages, advanced banks incur a number of additional imposts not reflected in the headline IRB risk weight.¹³

A like for like comparison needs to consider the following impacts to IRB risk weights, either directly or via the equivalent risk weight impact to achieve the same Return on Equity (RoE):

- 1) The higher capital charge to major banks from the D-SIB¹⁴ surcharge;
- 2) Requirements on advanced banks to hold additional RWAs for IRRBB;
- 3) The higher RWA requirement on IRB banks for undrawn (unutilised) balances. Specifically, we note that the Credit Conversion Factor used for off-balance sheet exposures is higher in IRB modelling compared with standardised approaches;
- 4) Compliance costs in maintaining advanced accreditation;¹⁵
- 5) Initial investment in systems and capability to obtain advanced accreditation. Whilst this has been a significant investment for advanced banks, recent improvements in technology and modelling capability of third party providers will mean that this should not be as significant a barrier to banks achieving advanced accreditation today;
- 6) Differences in mortgage quality between IRB and standardised banks:
 - Advanced modelling approaches should deliver better risk discrimination and, over time, a higher quality mortgage book through better understanding of risk.
 - For a meaningful comparison, NAB has calculated the risk weights an advanced bank would be expected to hold on a portfolio with the delinquency and default rates of a standardised bank.

- 7) The greater portfolio diversification achieved by advanced banks:
 - The IRB Basel mortgage risk weight function is calibrated to the loss data from 'large internationally active banks'.¹⁶
 - For a less diversified bank to use this approach without due care may be to misuse the implied correlations in the function.¹⁷
 - Portfolios with concentrations in particular regions are susceptible to localised volatility in defaults, warranting higher capital allocation.
- 8) The point in the economic cycle at which comparisons are made:
 - Losses in the mortgage book are currently at cyclically low levels.
 - IRB risk weights can be expected to increase as these losses normalise, while standardised risk weights will be unaffected.

Adjusting for these factors produces a risk weight gap of ~7%, as illustrated in the following chart. This translates into a 6bp differential in pricing to achieve the same RoE. That is, standardised banks would need to charge 6bp more to achieve the same RoE, based on the approach outlined in APRA's submission to the FSI.

No competitive disadvantage

On balance, NAB does not believe that this small difference is resulting in a competitive disadvantage for standardised banks, nor is it sufficient to distort the mortgage market via modifying current risk settings. Conversely, a small differential in risk weights between standardised and advanced approaches is important to encourage banks to pursue advanced accreditation (as noted in the Basel framework).¹⁸ As a result, risks in the mortgage portfolio are better understood by ADIs operating under advanced accreditation and risks in the mortgage market overall are better understood by the industry, prudential regulators and policy makers.

Retaining this incentive should encourage standardised banks to achieve advanced accreditation. This pursuit should remain a commercial decision and not one that places banks using the standardised approach at a significant competitive disadvantage.

¹³ APRA, "Submission to the Financial System Inquiry", March 2014, p.75.

¹⁴ Domestic Systemically Important Banks.

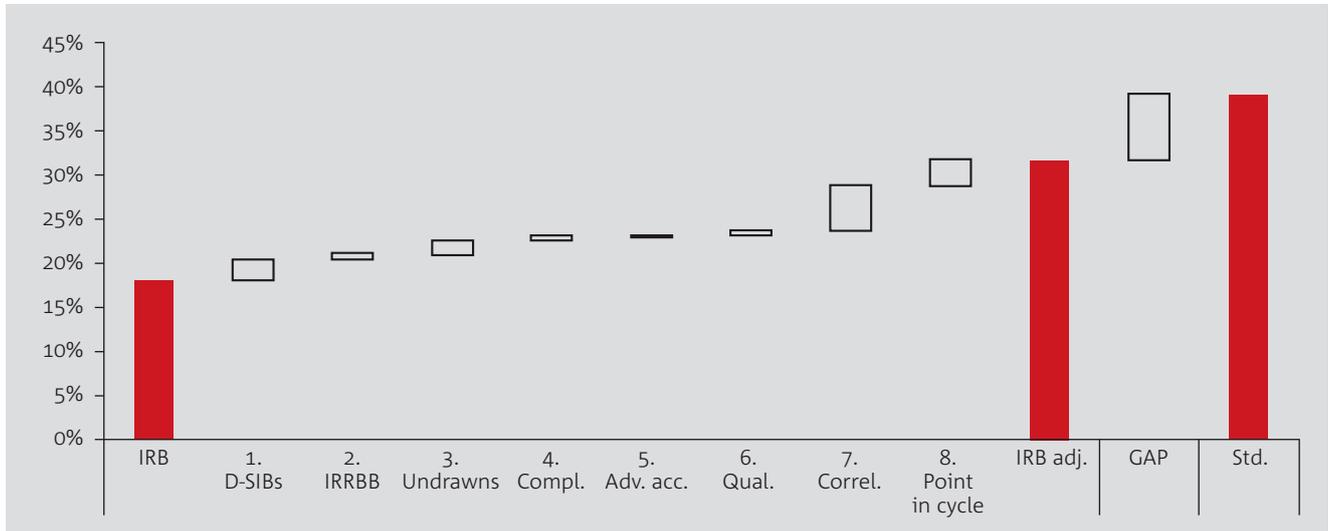
¹⁵ NAB's compliance costs have been used to determine the equivalent risk weight impost in the chart. It is reasonable to expect these are indicative of costs for each of the advanced banks.

¹⁶ BCBS, "An Explanatory Note on the Basel II IRB Risk Weight Functions", July 2005, p.14.

¹⁷ Advanced banks model the impact of portfolio diversification through economic capital models, as reported in their annual Internal Capital Adequacy Assessment Process (ICAAP). The additional RWAs NAB would expect to hold have been quantified on the basis of a portfolio distribution similar to a smaller bank. Banks with a large proportion of their mortgage book in one capital city are subject to greater price volatility than a well-diversified mortgage lender.

¹⁸ BCBS, "International Convergence of Capital Measurement and Capital Standards", June 2006, p.4.

Figure 1: Mortgage Risk Weight Comparison – Standardised versus Advanced



SOURCE: NAB internal modelling based on the approach outlined in APRA’s submission to the FSI.

No change to current risk weightings

NAB does not support the options of increasing IRB risk weights or lowering standardised risk weights (via tiering or lowering) in order to narrow the gap between IRB and standardised risk weights. Deviating from the Basel framework in this way will have a negative impact on perceptions of the Australian banking system and its integration with the other regulatory jurisdictions. As noted by the Inquiry, as an importer of capital, it is critical that Australia continues to adopt appropriate international standards. Further deviations from international standards would increase the relative complexity of the Australian banking market. We note that APRA finds that Australian housing loan risk weights under the IRB approach: “do not appear out of line with other jurisdictions”.¹⁹

NAB does not support the application of advanced IRB for mortgages only. This would appear at odds with expectations of the International Basel framework, whereby: “once a bank adopts an IRB approach for part of its holdings, it is expected to extend it across the entire banking group”.²⁰ Advanced accreditation is an integrated approach to credit decisioning, portfolio management, pricing, stress testing and understanding risk. Capital is then held at a level that is commensurate with a bank’s risk profile. Applying advanced accreditation for a component of a bank’s risk profile, without understanding the inter-relationship of risk, is contrary to the intent of advanced risk modelling. Further, the Basel Framework makes it clear that a bank moving to advanced accreditation should “not [be] motivated by a desire to adopt a Pillar 1 approach that minimises its capital charge”.²¹

Recommendation:

- No changes should be made to current arrangements for standardised and IRB risk weightings.

¹⁹ APRA, “Submission to the Financial System Inquiry”, March 2014, p.77, Figure 16.

²⁰ BCBS, “International Convergence of Capital Measurement and Capital Standards”, June 2006, p.61.

²¹ Ibid.

6. Superannuation

There is a perception that compulsory superannuation was designed to replace the Age Pension and that its failure to do so reflects poorly on superannuation providers and on the system overall. The Inquiry should set this matter straight. Compulsory superannuation was never designed, nor intended, to replace the Age pension. Rather, it was always intended to complement both the Age Pension and voluntary household savings, in a way that enhances retirement incomes overall.

Fees and Operating Costs in Superannuation

NAB believes that the focus should be on retirement outcomes for members, rather than merely on fee levels and charges. In this regard, the *Melbourne Mercer Global Pension Index* rates the Australian superannuation system as one of the best retirement systems in the world.²² Nevertheless, NAB believes that there is considerable evidence that competition in the market has driven down fees, and that recent initiatives, such as *MySuper*, will compress fees even further over coming years.

Superannuation fees have reduced considerably over the last decade

Average fees as a percentage of assets have reduced by 18% over the 11 years to 2013.²³ The fee reduction for large employer master trusts was even more significant, with fees reducing by 30% between 2002 and 2013. This was the result of employers and trustees seeking to improve member services and reduce their own costs through outsourcing. This has occurred despite the industry experiencing opposing forces of:

- Investment spending in modernising administration platforms;
- Increased choice;
- Increased disclosure and compliance requirements;²⁴
- Increased focus on member engagement, and;
- Increased regulatory levies.

MySuper has already reduced fees and will continue to do so

MySuper has been in operation since July, 2013, but early observations indicate that its introduction has already driven down fees:

- *MySuper* rules explicitly impose fee restrictions, including a ban on ‘commission’ and cost recovery on switching;
- The average fee for *MySuper* products in 2013 is 0.73%, which is 19bps lower than the default option in the same funds in 2011, and;
- Fees paid by *MySuper* members in corporate superannuation funds are often less than the headline pricing, as providers are able to pass on administration efficiencies through dealing with larger employers.²⁵

For many funds, *MySuper* balances are small at present. By 2017, NAB expects *MySuper* assets to be over half of the total assets within funds. As balances increase, we expect a further reduction in average fees.

Australian fees are not unreasonably high by international standards

A 2009 global comparison of various retirement systems has found that the fees charged by Australia’s largest superannuation funds compare favourably to the more competitive funds in the world.²⁶ This reflects the smaller number of large and efficiently run plans in Australia, and the willingness of many funds to outsource scale-based functions. Nevertheless, it is difficult to draw meaningful conclusions from international fee comparisons, as global retirement systems differ in numerous respects, such as:²⁷

- Plan structures (Defined Benefit versus Defined Contribution);
- Investment structures;
- Taxation structures;
- Insurance provision;
- Member services;
- Choice;
- Regulatory costs, and;
- Costs met by employers.

Given these differences, NAB believes that a more appropriate metric for international comparisons is overall retirement outcomes for individuals.

²² <http://www.globalpensionindex.com/>.

²³ Rice Warner, “*Superannuation Fees Report*”, May 2013. <http://ricewarner.com/media/96729/Rpt-FSC-Superannuation-Fees-Report-2013-FINAL.pdf>.

²⁴ Financial Services Reform Act (2001), Tax Laws Amendment (Simplified Superannuation) Act (2007), and Superannuation Legislation Amendment (Stronger Super) Act (2012).

²⁵ For example, NAB operated Plum Superannuation Fund has been able to reduce the administration fee from the standard rate for 95% of members of employer plans.

²⁶ Deloitte and IFSA, “*Australia compares well in global super fee study*”, 29 September 2009.

²⁷ Shelton, M. “*Chile’s Pension System: Background in Brief*”, Congressional Research Service Report, March 28, 2012.

Auction for default fund status is not the answer

A default fund auction based on fees would undoubtedly reduce fees incurred by default fund members. However it fails to account for the complexity of the Superannuation system and further guidance would be required around:

- Ensuring product features remain updated;
- Consequences if the chosen default fund underperforms equivalent funds;
- The dislocation caused when a tendered default changes;
- Concentration risks, and;
- Discouraging innovation except to the extent that the innovation reduces fees.

The Inquiry has noted the application of the Chilean auction model, but has not examined all aspect of the Chilean system, notably:

- The Chilean model has reduced fees for new workers only, but the retirement system itself does not necessarily lead to better retirement outcomes for the average worker;
- There is an economy of scale benefit, as only a handful of authorised funds accept retirement contributions in Chile. We believe that the recently introduced *MySuper* regime has delivered, and will continue to deliver, economies of scale in Australia with less concentration risk and more stability than the Chilean model, and;
- The Chilean system does not include insurance cost in the assessment process.

An auction based system needs to be contrasted with existing default superannuation arrangements in Australia. In *MySuper*, there are only 117 authorised products, inclusive of several employer-specific products. Excluding these, the number of funds authorised to accept default is significantly less than the anticipated number of *MySuper* products.

NAB expects to see further mergers and consolidations between funds, not least because of the *MySuper* scale determination test introduced by the Stronger Super regulations,²⁸ but also due to the benefit from scale, brand and distribution efficiencies afforded to larger default funds. This should lead to further reductions in fees.

Three day portability rule

The three day portability requirement introduced by Stronger Super creates two issues for the industry:

- a) **Impact on asset allocation and returns:** The previous portability requirements allowed superannuation funds between 14 and 30 days to complete a member rollover. Under normal circumstances, the time taken was much less, with most funds executing the transfer within 3 to 5 days. Hence, the initial belief that members were experiencing difficulty in receiving funds in a timely manner was incorrect for the vast majority of funds. A further consequence is that some funds are required to hold higher levels of liquid assets.
- b) **Reduced ability to deal with extreme market events:** While the legislation allows trustees to suspend redemptions for a period during which they do not believe equity between members can be maintained, there are regular circumstances (year end, state based holidays) and irregular events (significant market correction, major withdrawal period), where trustees cannot meet the three day redemption period without impacting member equity.²⁹ In these cases, the only course of action is to seek portability relief from APRA, so as not to breach the three day requirement.

Active vs. Passive management

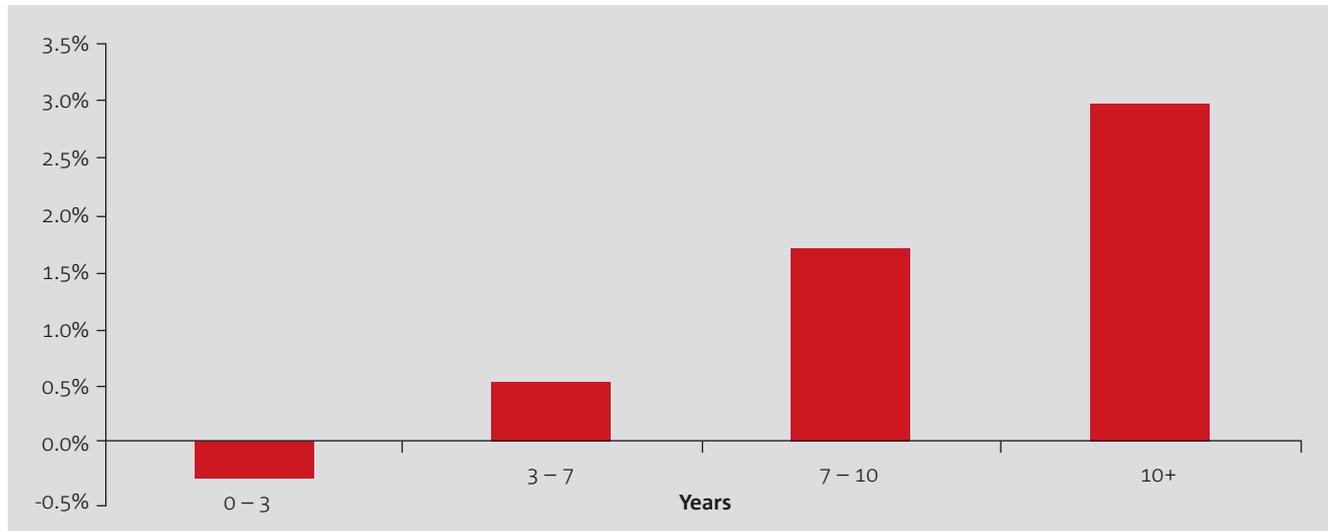
NAB believes it is possible to outperform the market through active management over the longer term. In 2013, JANA analysed the historical performance of active managers over time.³⁰

²⁸ *Superannuation Amendment (Trustee Obligations and Prudential Standards) Act* (2012), 529VN.

²⁹ *Superannuation Industry (Supervision) Act* (1993).

³⁰ We restricted the universe to the Australian and overseas equities mandates of funds advised by JANA for at least 15 years, in order to be able to track the long-term experience of our advised funds with active management. Note the data is net of fees.

Figure 2: Outperformance (net) over benchmark of active managed funds (by duration)



SOURCE: JANA.

The key findings of this analysis were:

- Since inception, active mandates had outperformed benchmark by 0.5% p.a. on average after fees.
- The longer mandates had been in place, the higher the level of outperformance.
- Outperformance is 'cyclical' (i.e. active management has periods where it is stronger than other periods).

Recommendations:

- The *MySuper* regime and its early impact on fee compression should continue to be monitored. Until the effectiveness of the *MySuper* regime can be assessed and reviewed, there should be no change to current arrangements.
- NAB does not support the proposed default auction process, as this will not improve retirement outcomes for members.
- NAB promotes full and open competition for default superannuation as a means of improving member outcomes and recommends that any remaining impediments that constrain employers from being able to nominate any *MySuper* product as their default superannuation fund be removed.
- Fund portability should be extended to between 14 and 30 days, so that the need for trustees to apply for relief would arise only in the most extreme circumstances.

7. Retirement Products

NAB agrees with the Inquiry's *Interim Report* that there is an opportunity for financial and policy innovation to deliver better outcomes for retirees, and thereby assist Australia to meet the challenges of an ageing population.

As the Inquiry's *Interim Report* has identified, there is a large body of evidence to support the assertion that people value longevity risk protection. This finding is supported by NAB/MLC's research:

- The December 2013 MLC Investment Trends Retirement Incomes Report shows that the three issues respondents were most worried about, but for which they had no plan, were:³¹
 - 'Outliving retirement savings';
 - 'Having enough for aged care', and;
 - 'Falls in financial markets'.
- The top three areas where they would like more or additional advice were:
 - 'Age Pension (and other entitlements)';
 - 'Plan to make super last for my life', and;
 - 'Choosing a retirement income product'.

Australia's retirement income system should enable Australians to choose how best to manage their longevity and financial risks, so as to increase 'self-reliance'. It also needs to support a range of different retirement income products (e.g. deferred, lifetime and variable annuities) insurance and asset management solutions that allow individuals to achieve the mix of income, risk management and flexibility appropriate to their circumstances.

Individuals may not necessarily make optimal decisions, due to poor financial literacy or behavioural biases. In this context, we believe that 'nudge' strategies may be appropriate, including default retirement options, policy incentives to manage identified risks, and member communications.

In relation to the specific policy options identified by the Inquiry, NAB's views are as follows:

Default option

- Trustees should be encouraged to develop a 'default retirement option' for individuals who do not make an active choice. As noted in The *Super System Review*, this could include contemplation of *MySuper* as a 'whole of life' product but with capacity to 'opt-out'.³²

- No particular product should be nominated as the default in legislation. Instead, the trustee should have the flexibility given the membership profile of the fund to develop the most appropriate approach. This would include a fiduciary requirement to consider longevity, market and inflation risk, as well as capacity and timing for 'opt out'.
- If the trustee adopts a default that operates as a pool or insurance-based option, then legislative protection should be created for their fiduciary obligations.
- All sectors of the superannuation industry (retail, industry, corporate, etc) should be entitled to develop or adopt solutions which qualify as a default income stream option, including via outsourced entities (which themselves may need to meet quality filters). This may necessitate controls, to ensure the solutions are 'fit for purpose'.
- Members should be able to 'opt out' of the default option, at minimal or no cost (excluding the cost of any risk premium paid and covered).

Mandating the use of particular retirement income products

- NAB does not support compulsion in relation to the use of particular retirement income products (in full or in part, for later stages in retirement). Individual needs and circumstances vary significantly and what will be appropriate for one fund member may not be appropriate for another.

Policy incentives

- NAB supports incentives encouraging Australians to consider and to take retirement products which support lifestyle outcomes in retirement (in other words, which provide longevity, market and inflation risk management features) in a 'product neutral' manner.
- For longevity products, incentives should contemplate exemption of the 'insurance premium' from the asset test and income test for the Age Pension.
- Any form of incentive provided should not favour a particular type of longevity product and should be constructed to include anti-avoidance provisions.

Member communications

- Currently, industry practices mean members are generally provided only with the account balance available on their statements. This creates an 'investment' mindset rather than an 'income' mindset. NAB supports shifting the focus away from solely accumulated account balances to one which focuses on projected retirement outcomes via regular member reporting.

³¹ MLC "Investment Trends Retirement Income Report", December 2013.

³² Australian Government, "Review into the Governance, Efficiency, Structure and Operation of Australia's Superannuation System, Final Report", Pt. 1, Ch. 1, p. 15.

- Consideration should be given to enabling or requiring superannuation statements to include projected income based on a given account balance (potentially including future contributions). This projection should incorporate risk, by either projecting multiple scenarios based on good and bad outcomes or, if a single outcome is used, the minimum income that would be guaranteed.
- Online calculators (and member statements) typically assume a single investment return and a single path, which is not useful in providing members with an understanding of possible retirement outcomes. Arguably, it can even be misleading. Calculators should convey risk concepts in a similar fashion, including the variability of life expectancy.
- Current risk metrics, such as a chance of loss four years out of twenty, are not, in isolation, meaningful. These should be revised based on industry consultation, to provide members with more meaningful data.

Retirement income products – options for consideration

The Interim Report notes that:

“...retirees require income products that deliver three main features: income, risk management and flexibility. No product provides all of these features.”³³

Whilst this is true in respect of account-based pensions and life-time annuities, products with these three features have been recently introduced in Australia. This newer generation of retirement products allows individuals to achieve the mix of retirement income, via the generation of returns and risk management and flexibility, appropriate to their circumstances.

Emerging ‘guarantee’ or ‘protection’ solutions in this market have the following characteristics:

- They are guarantees at an individual level.
- They can be conceived of as an allocated pension followed by a lifetime income stream when that allocated pension is exhausted.
- They typically guarantee a minimum withdrawal amount of 5% of the original capital; this compares to the ‘safe withdrawal rate’ historically of about 3%.³⁴
- They provide downside protection, in that they guarantee to return all capital, over time.
- The underlying investment, which is an account-based superannuation or pension policy held for the benefit of the member, is an investment in a diversified fund with equity exposure, which can be an effective way to generate wealth and provide an adequate income.

- The guarantee generally has a ‘rising floor’ based on the performance of the underlying asset and contributions.
- They provide liquidity, in that the account balance can be withdrawn at any time without penalty (other than foregoing future guarantees).
- The individual can commence the guarantee during accumulation, in which case market gains and contributions increase the guaranteed amount.

There is also a new generation of diversified funds which more directly manage risk and provide for enhanced consistency of retirement lifestyle:

- History illustrates the propensity for periodic significant negative real returns from traditional diversified funds, and the importance of inflation in eroding retiree purchasing power. The variable risk exposure of these funds erodes reliability in retirement. Inflation has historically been an important source of risk to investor lifestyle in retirement.
- ‘Objectives based’ funds provide continuous risk control over defined time periods. This compares with traditional diversified funds which have relatively rigid debt equity mixes which results in a variable risk exposure (because the riskiness of debt and equity changes through time).
- These strategies have very flexible asset allocations which are used to maximise expected returns, subject to limiting risk. They manage both sequencing and inflation risk (‘real return’ or objectives based funds), and are beginning to displace current traditional diversified funds.

In relation to information sought by the Inquiry on other retirement income product areas:

- Deferred Annuities and Group Self-Annuity (GSA):
 - Products currently exist in the Australian market that take the form of longevity insurance, and which operate like a ‘ruin contingent’ deferred annuity.
 - Term based deferred lifetime annuities (DLAs), where the purchase price is a single premium with a lifetime income payment that starts some years later, are one of the more effective mechanisms to distribute mortality credits, but have characteristics that may make them less attractive to individuals.
 - NAB believes term based DLAs serve a role and the superannuation laws should be amended to allow them.

³³ Financial System Inquiry, “Interim Report”, July 2014, p. 4-9.

³⁴ FINSIA, “How Safe are Safe Withdrawal Rates in Retirement? An Australian Perspective”, March 2014

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- NAB does not support GSA schemes due to design, disclosure and equity issues associated with tontine structures.
 - The private sector is well positioned to manage longevity risk if there is a large increase in the use of longevity-protected products.
 - Government provision of longevity insurance:
 - NAB does not support the Government provision of longevity insurance beyond current arrangements with the Age Pension, due to the Government’s current exposure to the Age Pension over the medium term.
 - Any initiative by the Government to increase the depth, duration and liquidity of financial instruments that help providers of retirement income to develop products that manage longevity risk, would be positive.
 - Ways to assess and compare retirement income products:
 - Income efficiency is one way to compare products, but it is significantly incomplete, as products vary by the degree of liquidity, potential growth, capital certainty, and other features such as the ability to make contributions during an accumulation phase.
 - Government (and regulators including ASIC) should consult with industry to develop a suite of metrics that, in aggregate, facilitate the understanding of income stream features and possible income stream outcomes.

Recommendations:

- Encourage funds to focus disclosure and communication (including calculators) on how much members’ savings will potentially produce as income replacement in retirement across a range of projected scenarios (poor, moderate or good outcomes).
- Remove impediments to, and consider incentives for, the development and adoption of income stream products or adjuncts which mitigate risks in retirement, including longevity risk.
- Remove impediments to the use of online interactive tools which allow members to test and model different scenarios (with reasonable controls).
- Enable trustees to create ‘default income stream’ options in the context of their fund membership profile, together with a fiduciary requirement to consider longevity, market and inflation risks.
- Consult further with industry on options to compare and assess income stream products.

8. Equity Release

NAB acknowledges that for many retirees, the majority of their wealth is held in the family home. As the Australian population continues to age, there will be greater emphasis on opportunities to access the equity accumulated within this asset to fund retirement needs.

NAB does not currently offer this product. We believe that there are a range of issues impacting the attractiveness and take-up of equity release products:

- **Complex regulation:** Currently, equity release products are uncommon and they are a riskier area for lenders in terms of NCCP and 'Responsible Lending' obligations.³⁵ The highly regulated nature of these products requires participants to be highly trained and to demonstrate a special level of expertise.³⁶ This added impost on distributors limits the availability and appetite to offer this type of product. Details as to how credit licensee holders, distributors and lenders can practically satisfy obligations require further clarification.
- **Specific support and guidance:** The complexity of equity release products and the sensitivity of the target customer profile require specific support and guidance to ensure contract terms and contract obligations are not deemed unconscionable.
- **Capital requirements:** The economic considerations of equity release products suggested in APRA's APG 223 draft guidelines include the proposal for increased capital holdings, making this type of product less attractive for lenders.³⁷
- **Operational, legal and reputational risk:** The provision of equity release products introduces increased origination requirements and a higher level of ongoing administration to manage legal and reputational risks. These risks have been highlighted in APRA's APG 223 draft guidelines.³⁸

NAB would welcome further debate and discussion on equity release products. This debate should address existing impediments, highlight the purpose of equity release products (e.g. home maintenance/improvements) versus supplementing retirement income, and should clarify the level of independent financial advice required by the borrower, prior to product purchase.

Recommendations:

- Further discussion and guidance is required regarding satisfying credit licensee requirements for equity release under NCCP, Responsible Lending and Unfair Contract Terms.
- Clarity around potential capital treatment of equity release products is required to understand economic implications for lenders.

³⁵ APRA ARG 209.67, which requires that inquiries ranging from future needs, an analysis of the equity position of the property and the provision of an equity projection be completed with the borrower, using a reverse mortgage calculator available on the ASIC website (www.moneySMART.gov.au).

³⁶ For example SEQUAL group who currently offer reverse mortgage accreditations.

³⁷ APRA APG 223 Paragraph 59, "APRA's capital standards are based upon amortising rather than reverse mortgages. An ADI undertaking a material volume of reverse mortgages could, as a matter of supervisory discretion, be required to hold additional capital against the unusual risks associated with this product."

³⁸ APRA APG 223 paragraph 58 "Reverse mortgage loans give rise to unique operational, legal and reputational risks, including in relation to consumer protection laws that could affect loan enforceability. Such measures could, amongst others, include: (a) assessment of the need for actuarial advice; (b) age-based caps on LVRs used for reverse mortgages; (c) documented procedures applicable to the regular revaluation of properties underpinning reverse mortgages; (d) cautioning borrowers against waiving independent legal and financial advice; and (e) higher levels of controls and monitoring when marketing such loans through third-party".

9. Financial Advice

The principle of advisers and clients agreeing to a fee for service remuneration structure, rather than product based commission incentives in respect of personal advice, has been a crucial change in removing conflicts. MLC's pioneering reforms in this area continue to serve its customers well, having avoided disruptions experienced elsewhere in the market. This is complemented by advisers' statutory duty to act first in the best interests of their client, rather than in their own or another party's interests, in the context of the advice relationship.

NAB believes that further opportunities for improvement exist and we refer the Inquiry to MLC's submission to the *Parliamentary Joint Committee on Corporations and Financial Services 2009 Inquiry into financial products and services in Australia*. We reference some of these recommendations in further detail below.

Education and competency standards

We believe that the existing and substantive ASIC guidance could be leveraged and adjusted to fit the proposed advice architecture, but with more substantial requirements applicable to those providing Tier 1 personal advice to retail clients.

NAB believes that ASIC's base minima criteria for financial planners is a useful starting point for new entrants to the industry and should be considered in conjunction with ASIC *Regulatory Guide 36 – Licensing: Financial Product advice and dealing* and *Regulatory Guide 175 – Licensing: Financial Product advisers – conduct and disclosure*.

Specifically, NAB proposes that:

- a) Subject to a new regulatory architecture, a structured qualifications framework including, as some professions require, a period of internship for personal advice in respect of more complex products (currently classed as Tier 1) or strategic advice areas where specialist accreditation would be warranted such as Aged Care, Estate Planning and Business Succession.
- b) New entrants from 2018 who provide Tier 1 or complex strategic personal advice should complete a relevant undergraduate degree.
- c) Existing planners should be subject to a National Exam (which may comprise modules) as determined by a 'National Competency Board' and in line with any refinements to the advice architecture.
- d) An enhanced central public register of financial advisers should be established, including employee / salaried advisers, providing personal advice to retail clients on 'Tier 1 products' and, subject to any refinement in advice architecture, complex strategies.

Regulatory advice architecture

NAB believes there is a need to review the existing financial advice legislative model. Currently the model is categorised into: factual information, general advice and personal advice focused predominantly on product recommendations.

There are two deficiencies with this approach:

- a) It fails to properly deal with the different methods of advice delivery. The current structure is focused on comprehensive full advice in a face to face meeting. It does not take into account the other methods of advice delivery, such as phone or online.
- b) Based on the current advice categorisation, most advisers will focus on providing comprehensive personal advice, which leads to financial product recommendations.

The existing financial advice market still consists predominantly of holistic and high cost face to face advice that remains out of reach of up to 80% of Australians.³⁹ The need for different access points and models was, and still is, apparent. Scaled models, including intra-fund superannuation advice and digital online tools, provide a significant opportunity to build engagement. While these models are still in their infancy, they are creating engagement with the advice process.

A more tiered approach with associated competencies should 'fit' vertically integrated as well as 'independent' structures, with the latter designation only utilised where all criteria in the law are met (and it is recorded on the central register of financial advisers). As a guide the framework may develop, with refinement, along the following lines:

- **Information only:** Allows employees of a financial institution to provide information in respect of only that institutions' products and services. It may include explicit identification and explanation of the products or services related to a consumer inquiry. This would require similar warnings as currently exist in respect of General Product Advice.
- **Financial strategy advice only:** Allows appropriately qualified advisers and employees to provide strategic planning advice, but without specific product recommendations.

- **Limited advice:** The above, plus capacity to provide personal advice on a limited range of Tier 1 financial subjects, products and/or services (including intra-fund and scaled advice).
- **Full service advice:** The above, plus personal advice on the full suite of financial subjects and approved products and services of their licensee.
- **SMSF advice:** The above, plus capacity to advise on the structure, requirements and obligations of SMSF trustees.

Vertically integrated models, independent and aligned advice

The Interim Report⁴⁰ notes:

“Some submissions argue that lack of structural independence can impair the quality of advice. Others argue it is not ownership but remuneration that creates conflicts that reduce quality.”

The report also states that:

“Some submissions argue it can be difficult for consumers to know whether an adviser is aligned or independent, and that consumers may not appreciate the potential implications for the products they are offered.”

While vertically integrated models do contain some conflicts of interest, the key is understanding and identifying these conflicts, so they can either be removed or addressed. NAB believes that conflicts can be managed through appropriate governance structures, stringent product selection processes, review and monitoring of advice and rigorous compliance frameworks.

NAB submits that the benefits of a properly managed and vertically integrated model outweigh the potential negatives. They can provide secure and holistic financial services and also have the capacity to deliver consumer protection capabilities in the event of fraud or operational risk.

The interim report also noted:⁴¹

“Currently, approximately 15 per cent of advisers are fully independent (part of a practice with its own AFSL); 29 per cent of advisers are part of a majority independent dealer group (0–49 per cent institutionally owned); whereas, 56 per cent belong to dealer groups that are majority owned by institutions or other wealth managers, or are part of a bank branch network.”

As identified in the footnotes of the Report, this is not an accurate description of ‘independence’. Under the *Corporations Act*,⁴² a licensee (AFSL) or authorised representative will breach their obligation unless they comply with a number of requirements, broadly as follows:

- no receipt of any (by the licensee, the authorised representative or the authorised representative’s employer):
 - commissions (unless fully rebated to client);
 - volume-related remuneration, and;
 - gifts or benefits from a product issuer.
- the licensee or the authorised representative operates ‘free from any direct or indirect restrictions relating to the financial products in respect of which they provide financial services’ – e.g. Approved Product List restrictions.
- the licensee or the authorised representative operates without any conflicts of interest arising from associations or relationships with product issuers that might reasonably be expected to influence the licensee or the authorised representative.

Hence, merely being identified as their ‘Own AFSL’ (or majority ‘independently owned’), does not indicate independence and this is a clear area of confusion for consumers.

It is also the case that authorised representatives or employees of a licensee must, in various disclosure documents, including comprehensive Statements of Advice (SOA) identify the licensee (ownership structure).

We believe the significant changes of the FOFA regime mitigate risks of conflicts substantially.

40 Financial System Inquiry, “Interim Report”, July 2014, p.3-72.

41 Ibid.

42 *Corporations Act* (2001), s923A.

Recommendations:

Education and competency standards:

- Minimum education standards should be raised and competency standards formalised.
- An enhanced register of financial advisers advising on Tier 1 products (or complex strategies) should be developed, including a designation of 'independent' only where applicable to both the adviser and their licensee under the legislated provisions. The register and/or SOAs could be enhanced to show shareholding or majority ownership of license.
- Establish a National Competency Board with professional associations and regulators represented on the Board. Sub-committees should have financial planner or licensee representation.
- Review ongoing education requirements under the auspices of a National Competency Board and existing professional bodies.
- 'Tier 1 Financial Advisers' should be required to have membership in an accredited and recognised professional body.
- The National Competency Board should develop a set of standards for minimum competency across the advice architecture model (excluding factual). NAB supports:

- a) New entrant 'Tier 1 Financial Advisers' from 2018 providing personal advice or complex strategic advice to retail clients having a relevant tertiary qualification.
- b) Existing planners being subject to a National Exam.
- c) Specialist accreditation being required for SMSFs and other strategic advice areas such as Aged Care, Estate Planning and Business Succession (as specialist electives).

Regulatory advice architecture:

- Consideration should be given to refining the regulatory advice architecture in the *Corporations Act* – currently based on product recommendations and segmented into factual information, general advice, and personal advice.

Vertically integrated models, independent and aligned advice:

- The customer experience with vertically integrated entities can be enhanced through: a) Refinement of existing disclosure, and; b) Improved governance models for licensees.

10. Rationalisation of Legacy Products

Banking

NAB has not experienced any notable impediments to rationalising its banking products. There have been 181 banking products rationalised to date as part of NAB's NextGen program and further product rationalisation is planned.

Wealth

The current financial services laws render the rationalisation of wealth products as either too difficult or too expensive and although a practical regime exists for trustee issued superannuation products, there is still room for enhancement. Many customers are effectively locked into out-dated or uneconomic financial products and industry participants are locked into out-dated technology systems that are increasingly difficult to support.

NAB believes that regulation should be introduced that enables financial services institutions to more easily update technology infrastructure underpinning financial products, and to introduce a simplified, ongoing process to enable customers to be moved from out-dated products (legacy products) to more suitable modern products, with better outcomes for the customer. Positive outcomes for consumers are a result of:

- a) improved disclosure;
- b) reduced operational risk;
- c) improved safety;
- d) access to new and innovative investment opportunities;
- e) enhanced competitiveness, and;
- f) cost reduction.

Barriers to implementing product rationalisation in Wealth

Managed investment schemes:

The absence of a legal framework for transferring account holders between Managed Investment Schemes (MIS) means that each instance of rationalisation involves a termination (or winding-up) of a trust and a return of cash to the accountholder. If the product provider has a suitable alternative to offer, the customer needs to undergo a new application process. There are a number of significant disadvantages to this process, including:

- Benefits only accrue once all of the customers in a scheme are transferred to the new product.
- Higher costs of maintaining legacy products and systems are distributed over a smaller customer base.
- Existing legislation does not allow the suspending of scheme withdrawals while the scheme is being terminated.

- Issues in relation to 'in specie' transfer of assets of the terminating scheme in consideration of the granting of units to transferring beneficiaries.
- There is no mechanism to deal with lost beneficiaries (unlike superannuation, for example, Eligible Rollover Funds).
- Restructures and asset transfers between investment entities may give rise to taxation consequences, including CGT.
- Operational risk increases as legacy products age, due to loss of product knowledge in the business.

Life office products:

Outside of trustee owned policies, there is no regulatory scheme which allows the unilateral termination of insurance contracts required for rationalisation. Generally, product rationalisation requires voluntary actions by the policyholder.

- A Life Company cannot always guarantee that every policyholder's benefits, under the replacement product, will always be at least equivalent to or better than the original product. Industry needs legislative changes that allow disadvantaged policyholders to be dealt with on a case-by-case basis with a full suite of protective measures.
- If rationalisation is voluntary, it is still unlikely that every policyholder could be contacted. The Insurer will still retain some policies within the product and the product rationalisation benefits cannot be realised.
- Impact of tax treatment on life insurance bonuses.

Systemic issues to grandfathering

There is a concern that by maintaining legacy products, systems and processes that this exposes the industry and customers to various systemic risks and issues that could be removed through rationalisation. Manual processes are often implemented for legacy products as a less costly and faster response, but these can be prone to error.

Managed investment schemes:

The corollary of administrative complexity is increased operational risk, through both administrative mistakes and fraud. This is difficult and expensive to manage, with legacy products often excluded from standardised systems, procedures and risk management processes. Further concerns include:

- Legacy systems can be difficult and expensive to update for new regulation and disclosure obligations. This increase fees to customers.
- There is a greater risk of unit pricing errors.
- Further costs for regulators.

- Greater operational risk due to staff attrition and limited corporate knowledge.
- ‘Last man standing’ risk for some customers.

Life office products:

Specific issues in life office legacy products include:

- The contractual nature of life policies make it difficult for an Insurer to both fulfil contract terms and comply with current legislation.
- Limited knowledge of product features and benefits can lead to poor decision making and insufficient planning for retirement.
- This increases the risk of policyholders getting inadequate advice.

Benefits for Customers

Through the rationalisation of legacy products, customers will also benefit potentially through reduced fees and improved benefits and features. However it is noted that the benefits to customers will be very dependent upon the nature of the solution offered to them.

- Today’s legacy products were sold in the pre-FoFA era and most legacy products have some level of commission embedded in their pricing structure. By comparison, new products will have FoFA-compliant methods of adviser remuneration.
- Customers in legacy products generally experience deteriorating levels of service, poor product design relative to modern products, higher costs and exposure to the risk of losses due to error or fraud. Moving customers to contemporary products would dramatically improve service and features and reduce risks and costs.
- Service levels for customers may improve as a result of a number of factors including the following:
 - Increased understanding of contemporary products by call centre and administrative staff;
 - Improved administration systems, and;
 - Increased online access to product information and administration.
- Access to current and accurate investment advice from financial advisers.
- Independent information from research houses on current product performance.
- Improved policy benefits and features.

Trustee issued superannuation products

A practical regime already exists for the rationalisation of trustee issued superannuation products (such as the successor fund transfer provisions). However, the regime could still be enhanced to make it more effective, providing further opportunity for rationalisation and customer upgrades.

Product rationalisation via successor fund transfers involves expensive and lengthy projects, which lead to cost pressures and delays in providing members with access to new features and benefits. Aspects of transfers which could benefit from improvement may include, but are not limited to the following:

- Legal expenses incurred in advising respective trustees are often considerable. Our experience of Successor fund transfers is that separate legal resources are needed for the transferring and receiving funds to maintain independence of advice.
- Successor Fund Transfers may involve a minority of members that are not expected to be better off on some aspect of the transfer, either with respect to an individual product feature, or from transaction costs associated with the transfer.
- Transfers involve transaction costs in the sell down and re-acquisition of assets. The consequences for the members or the product providers are a key consideration in undertaking the transfer.

Recommendations:

- Specific alteration to Financial Services and Taxation laws is required to allow product issuers to transfer customers to contemporary products.
- The successor fund transfer provisions could be supported by the development of an industry backed guide for Successor Fund Transfers, similar to the Unit Pricing Guide for Good Practice issued by APRA and ASIC in August 2008.

11. Payment Systems

Electronic payments play an important role in economic development

In the *Interim Report*, the premise has been made (as part of both the interchange and surcharging discussion) that cash has either no or low cost associated with it.⁴³ It is NAB's belief that all payment methods have an associated cost. This view is supported by an increasing body of research:

- Melbourne University has concluded that the increased use of electronic payments and the subsequent reduction in the use of cash facilitates the growth of economic activity, as electronic payments are less costly than non-electronic payments.⁴⁴
- Bank of Canada's research paper shows that debit cards are the cheapest payment method for a \$36.50 transaction which is the median cash transaction amount captured in the survey.⁴⁵
- Tufts University's study on the cost of cash in the United States suggests the cost of cash on consumers, businesses and government amounts to at least US\$200bn or 3.3% of median household income.⁴⁶
- McKinsey & Company proved high cash usage perpetuates a shadow economy and hinders the evolution of a digital economy. Its analysis indicates that cash generates a high social cost, exceeding 1% of GDP, which is carried mostly by banks and merchants.⁴⁷
- Research carried out in the UK by Centre of Retail Research shows the cost of handling cash (2.75%), as a percentage of receipts, is far higher than that of cheques (1.96%) and more than double the cost of debit and credit cards combined (1.10%).⁴⁸

The common thread throughout these studies is the positive role that electronic payments play, in both increasing economic activity and heightening levels of consumer empowerment and choice, as well as reducing the need for cash transaction monitoring.

Interchange

NAB agrees with the Inquiry's observation that different payment systems, performing similar functions, are being regulated differently. Many payment systems (American Express, Diners, PayPal, Union Pay International and online payment systems) have received considerably less regulatory attention than others.⁴⁹ This puts some payment schemes at a competitive disadvantage and distorts the market. Consequently, the *Payment System (Regulation) Act 1998* should include a wider catchment of payment methods.

From a consumer's perspective, four party schemes and companion cards provide identical functionality. NAB does not see any difference between the four party schemes and the companion card model and therefore accepts the suggestion that companion cards should be regulated on a consistent basis.

NAB does not support the lowering or banning of interchange fees. If all payment products were included, the 'indifference test' could be appropriate. However, as this is not the case, the test is not competitively neutral and, rather than creating a level playing field, is biased toward cash. It does not provide fair value to our customers that choose to pay via cards instead of cash.

If interchange fees are lowered or banned, financial institutions would adjust their business models, as well as product fees and charges, to ensure cost recovery. This occurred when the RBA first designated interchange in 2004. There are a number of ways interchange income could be replaced. Issuers could:

- a) increase interest rates;
- b) Implement an annual fee increase, or;
- c) Introduce a transaction fee.

These actions would further incentivise consumers to use cash instead of electronic methods of payment. Lower levels of interchange paid to issuers makes investment in innovation less attractive.

Banning interchange fees altogether could require banks to take significantly more draconian measures than those outlined above. At the extreme, it could mean decommissioning of products targeted at non-interest bearing customers. NAB believes the interchange mechanism remains an important component of an electronic payment system.

43 Financial System Inquiry, "*Interim Report*", p.xix, "*The caps have also most likely reduced cross subsidisation from customers who use low cost payment mechanisms such as cash, to those who use high cost payment schemes.*" and p.2-29 "*Allowing merchants to surcharge customers for the reasonable cost of acceptance improves efficiency*".

44 Melbourne University, Melbourne Institute of Applied Economic and Social Research, 2013.

45 Bank of Canada, "*Bank of Canada Review – Winter 2008-2009*." January 2009.

46 The Fletcher School of Law and Diplomacy, "*The Cost of Cash in the United States*", Tufts University.

47 McKinsey "*Report on Payments*", March 2013, Exhibit 1,2 and 3.

48 Barnfield, J. "*Payment Systems in UK Retailing*" 2006-2007, Centre for Retail Research.

49 Financial System Inquiry, "*Interim Report*", July 2014, p. 1-13.

Cap differences in interchange service fees

NAB is in favour of a simpler, more standardised approach to interchange, as the current model is being applied unfairly.

There has been a proliferation of interchange rates since the reform package was introduced in 2006. Product type, merchant category, and merchant size have influenced interchange levels. The unintended consequence of the weighted average approach has been that Payment Schemes have created a significant spread of interchange rates,

whilst still remaining within the overall weighted average. Strategic merchants with market power and a high volume of transactions have been able to obtain significantly discounted interchange rates, reducing the overall weighted average. This has created the ability for both Card Schemes and banks to develop super premium products that have exploited the upper quartile of interchange scale with significantly higher interchange rates. Since the last reset, these have grown significantly, as illustrated below.

Figure 3: NAB Acquiring Interchange Payments Excluding Industry and Strategic Merchant Rates (November 2012 – June 2014)



Includes domestic cardholder spend and charities. SOURCE: NAB Acquiring Interchange.

As a result, smaller merchants are being disadvantaged and are carrying a disproportionate amount of the acceptance costs, making it increasingly difficult for them to compete.

NAB supports the following:

- Simplifying interchange tiers to provide greater levels of clarity for all stakeholders. The exception of 0% for entities with charity or non-for-profit tax status is appropriate and should be retained.
- Retaining existing debit card interchange at 12 cents per transaction and credit cards at 50bps weighted average interchange cap, and introducing both a floor and cap, to ensure a fairer differential between small and large merchants and between product types.
- Encouraging a narrower interchange range to provide merchants with greater certainty of payment costs associated with card acceptance, such that they could no longer justify surcharging. A narrower range would lead to a fairer exchange of value between banks, consumers, merchants and the wider community.

Merchants routing choice and real time pricing information

The Australian market is highly competitive amongst acquirers, giving merchants the ability to source low cost acquiring options and functionality.

The adoption of a standardised approach to interchange fees negates the need for these capabilities. As an outcome of undertakings provided by MasterCard, Visa and EFTPOS to the RBA on multi-scheme/application debit cards, the EFTPOS scheme and its members conducted workshops to assess the viability of permitting a merchant to determine which scheme to route transactions. The evaluation highlighted the cost and complexity of such an approach and that it would adversely impact transaction timing.

Equally, network routing, other than that expected by the cardholder, might result in the funds being withdrawn from a different account to the one expected by the cardholder or certain features (chargeback, zero liability, data security, and insurance) being unavailable.

Surcharging

Current surcharging is concentrated, typically within a small group of large merchants who have market power or a geographically captive audience. Smaller merchants without such market power, who do not enjoy discounted interchange rates from the Schemes, are disadvantaged. We believe surcharging does not reflect reasonable cost recovery, but rather, creates an unfair advantage for some merchants. It also provides an inconsistent experience for consumers, as it does not provide clear pricing signals about the relative cost of different payment options.

NAB believes surcharging is inherently unfair to the consumer and that it should not be allowed. It is inequitable to surcharge for some payment products, while other payment methods remain untouched. NAB favours that all payment types be treated in a 'competitively neutral' way and that legislation be amended to allow payment schemes to re-introduce the 'No Surcharge' rule. We do not support 'reasonable cost recovery' given the subjectivity of the term 'reasonable' and the potential complexity involved in drafting specific legislation (for example, only allowing for recovery of interchange and the merchant service fee and excluding indirect costs).

Recommendations:

- Interchange fee caps should be expanded to include payments of similar economic substance.
- Differences in interchange should be capped by retaining the existing weighted average fee and introducing both a floor and cap.
- Proposals that allow merchant choice and ensure that cardholders are the only party able to determine the routing of a transaction should be rejected.
- Schemes should be allowed to reintroduce the 'No Surcharge' rules.

12. The Role of Superannuation In Funding Australia's Growth

As the FSI notes, as at 31 March 2014, Australian superannuation assets were \$1.8Tr. At the end of 2013, this was 60% the size of banking system assets, versus 50% in 1997.⁵⁰

We refer the FSI to the ABA's submission to the Inquiry by Rice Warner: *Appendix D: 'Linking Superannuation to Funding and The Broader Economy'*. It shows that this large and growing pool of national savings is funding Australia's economic growth, through Australian Equities (33.9%), Cash and Term Deposits (17.1%), and Australian Fixed Interest (7.6%).⁵¹

Superannuation assets will continue to grow, with estimates that it will reach between \$9Tr to over \$12Tr by 2040.⁵² As the population ages and a growing proportion of Australians move from accumulation to drawdown phase, this will increasingly call for investments in more defensive asset classes, including cash and deposits, as well as fixed interest investments. A major challenge will be to ensure that this growing pool of savings continues to fund Australia's growth, through the provision of funding for Australian financial intermediaries and via the development of a domestic bond market.

As noted in the International Monetary Fund's (IMF) most recent Financial System Stability Assessment for Australia, the reliance of Australian banks on offshore funding remains a potential source of risk.⁵³ Superannuation can play a greater role in funding Australian intermediaries than is currently the case.

NAB's Interim submission to the FSI identified the two key impediments to greater use of interest earning investments such as deposits for Australian superannuation funds, namely⁵⁴:

- a) The tax disadvantage of interest bearing investments, including deposits, relative to other investment assets. This matter should be addressed as part of the Tax White Paper.
- b) Deposits from superannuation funds other than Self-Managed Superannuation Funds (SMSF) carry a less favourable treatment under the APRA Basel III requirements for calculating the liquidity coverage ratio (LCR). As a result of this discrepancy, it is difficult for Australian ADI's to offer sufficient returns to large superannuation funds, to make deposits attractive to them. This should be addressed by APRA introducing a new run-off category for superannuation deposits at a 50% runoff rate, still higher than corporate deposits (40%), but less than the run-off assumption for a bank or other financial institution (100%).

Recommendation:

- APRA should introduce a new run-off category for superannuation deposits which has a 50% runoff rate assumption.

⁵⁰ Financial System Inquiry, "Interim Report", July 2014, p.2-82.

⁵¹ Rice Warner, "ABA Submission to the FSI, Appendix D: 'Linking Superannuation to Funding and the Broader Economy'", February 2014, p.11.

⁵² Financial System Inquiry, "Interim Report", July 2014, p.2-84.

⁵³ International Monetary Fund, "Financial System Stability Assessment, Australia", 26 October, 2012.

⁵⁴ NAB "Submission to the Financial System Inquiry", March 2014, p.10.

13. Domestic Bond Market

Rice Warner has identified several sound reasons why Australian superannuation funds have a relatively low asset allocation to fixed interest investments by world standards.⁵⁵ Key amongst these are:

- The Defined Contribution (DC) structure of most Australian superannuation funds requires a more growth oriented asset allocation than Defined Benefit (DB) plans, which require asset and liability matching;
- Franking credits make equities more tax effective than other asset classes,
- The absence of a lifetime annuity market;
- High gross returns paid on bank deposits (with a government guarantee up to \$250,000) make bank deposits more attractive than fixed interest;
- A small supply of long dated Australian government bonds, and;
- The absence of an efficient secondary bond market.

Notwithstanding the above, NAB believes that the following initiatives will assist the growth of the Australian domestic bond market.

Simple Corporate Bond legislation

NAB has long supported the development of Simple Corporate Bond legislation. This bill represents a solid first step in facilitating easier retail debt issuances, by reducing requirements to issue a full prospectus and liability for directors. Until the legislation's impact on the market becomes evident, it is uncertain whether further changes will be required. What will be paramount is that balance exists between disclosure and access.

To determine the impact of this change, NAB suggests that the Government considers undertaking a post-implementation review at least 12 months following the Simple Corporate Bond Legislation coming into effect.

Size and scale of corporate vanilla bond offerings without a prospectus

NAB believes that it is difficult to see how proposals that call for a change to the size and scale of corporate bond offerings would be valuable, given the trade-off between the size of the issue and management time required to issue the bond. Specifically, we see two problems with this proposal:

- 1) The size of the offering being proposed by some (\$2m to \$10m) is too small to be liquid or to be attractive to investors in the primary market.
- 2) Without a prospectus, secondary trading is likely to be limited.

Demand for fixed income in retirement in the absence of other incentives

As the growing investor population enters retirement, stable returns will be sought to mitigate volatility in the market. Adding corporate bonds to an investment portfolio improves the risk-expected return combinations available, and while the market price of corporate bonds can fluctuate, if held to maturity they can provide a pre-specified cash flow over that period.

In order to assess whether or not regulations or other incentives are required to encourage retirees, NAB believes it is necessary to see how the market reacts following the introduction of the Simple Corporate Bond legislation. This will allow an assessment to be made of the correct balance required between disclosure and access.

Growth in Fixed Income markets through annuity-style products

The development of annuity-style retirement income investment products will not necessarily encourage the growth of fixed income markets, as this growth will be highly dependent on the nature of the annuity style product and its features. For example, it may increase demand for some specific areas of the fixed income market, for example inflation linked products, if, for example the annuity style product is inflation adjusted.

Nevertheless, irrespective of product design, the development of annuity-style income investment products will increase general education and awareness of products that are required in retirement.

Enhanced transparency of OTC transactions

Enhanced transparency is unlikely to change the attractiveness of the Over-the-Counter Australian corporate bond market to retail investors. This is due to the *Corporations Act* (2001), which restricts the selling of over-the-counter (OTC) products to non-wholesale investors.

The current criteria for an investor to be deemed a 'wholesale investor' restricts the number of participants in the OTC market. With a finite number of investors that can participate, the existing level of transparency is deemed sufficient.

The implementation of the Simple Corporate Bond legislation should provide opportunities for retail investors to participate in debt offerings that are currently only available in the OTC market. However, it is expected issuers will continue to favour issuing into the OTC market, due to the regulatory difference between the ASX listed market and the OTC market.

⁵⁵ Rice Warner, "ABA Submission to the FSJ, Appendix D: "Linking Superannuation to Funding and the Broader Economy", February 2014, p12.

Impact of alternative credit rating schemes and barriers to their development

The Australian domestic bond market is currently dominated by one credit agency, which has a strong focus on institutions and provides support for their issuances. (The other two credit rating agencies do not have as strong a presence in this specific segment). Having a fourth rating agency in the market that specialised in medium sized companies could provide a benefit to these companies when issuing bonds, however, this could prove challenging. An alternative would be if an existing rating agency were to develop a small to medium enterprise (SME) rating methodology. Using its established brand and history in the market, this agency would then have authority when rating these corporate bond issuances, providing support for this asset class.

Assessing credit risk of debt securities and corporate bonds is currently a complex and specialised task. Ultimately the investor is faced with the question of whether the yield offered is adequate for the risks involved. External credit ratings would assist investors in making this assessment. Currently, the only way in which investors can obtain a perspective on what price other investors are putting on these risks, is by comparing the promised returns on primary issuance to returns offered in the secondary market.

Recommendation:

- The impact of the Simple Corporate Bond legislation should be reviewed, before any further changes are made to the issue of 'vanilla bonds' to retail investors.

14. Infrastructure Financing

As noted in NAB's submission to the Productivity Commission Inquiry into Public Infrastructure, financing for large scale, long-term Australian infrastructure projects will need to come from a variety of public and private sector sources.⁵⁶

To facilitate this investment, NAB views the development of an Australian corporate bond market as central, but there are a number of impediments, which were outlined in NAB's first round submission to the Inquiry.⁵⁷ As described in NAB's submission to the Productivity Commission, specific barriers for infrastructure include:

- **Complexity:** Risk analysis of infrastructure investments may be considered complex, particularly in greenfields transactions. The procurement of external credit ratings to create risk visibility and/or minimum public financial disclosure would ensure adequate public information for retail investors to understand project risks.
- **Current bid process:** As the current market requires bids to be submitted with committed financing without price flexibility, it is difficult to develop a market for underwriters to provide firm bond pricing at the time of bid lodgement, which will carry to the time of bond issue at financial close. Therefore, bank debt is usually procured at the bid stage, to allow for price certainty.
- **Insufficient return:** Domestic institutional and sub-institutional investors generally require returns that are significantly higher than what the borrower can obtain through bank loans or domestic investment grade rated Medium Term Note (MTN) markets.
- **Familiarity:** Due to the lack of availability of infrastructure-related bonds beyond the domestic MTN market, the broader investor base is not familiar with this asset class and has limited allocation to fixed income product.
- **Structure of the Australian superannuation system:** Although super funds have demonstrated willingness to invest in infrastructure assets at an equity level, there is no incentive for them to match fund liabilities and invest in longer term assets.

Recommendation:

- The development of external credit ratings should be encouraged to create risk visibility and/or minimum public financial disclosure (similar to that required under ASX listing rules), which address concerns around ensuring adequate public information for retail investors to understand project risks.

⁵⁶ National Australia Bank, 'NAB submission to the Productivity Commission Inquiry into Public Infrastructure', www.pc.gov.au/_data/assets/pdf_file/0016/135250/subdr124-infrastructure.pdf, April 2014.

⁵⁷ National Australia Bank, 'NAB submission to the Financial System Inquiry', March 2014.

15. SME Access to Funding

Small and Medium Enterprises access to credit

We refer the Committee to the report, 'Small Business: Access to Finance – Year to March 2013', which was commissioned with the expressed purpose of building a robust data set around issues facing SMEs seeking to access to finance.⁵⁸

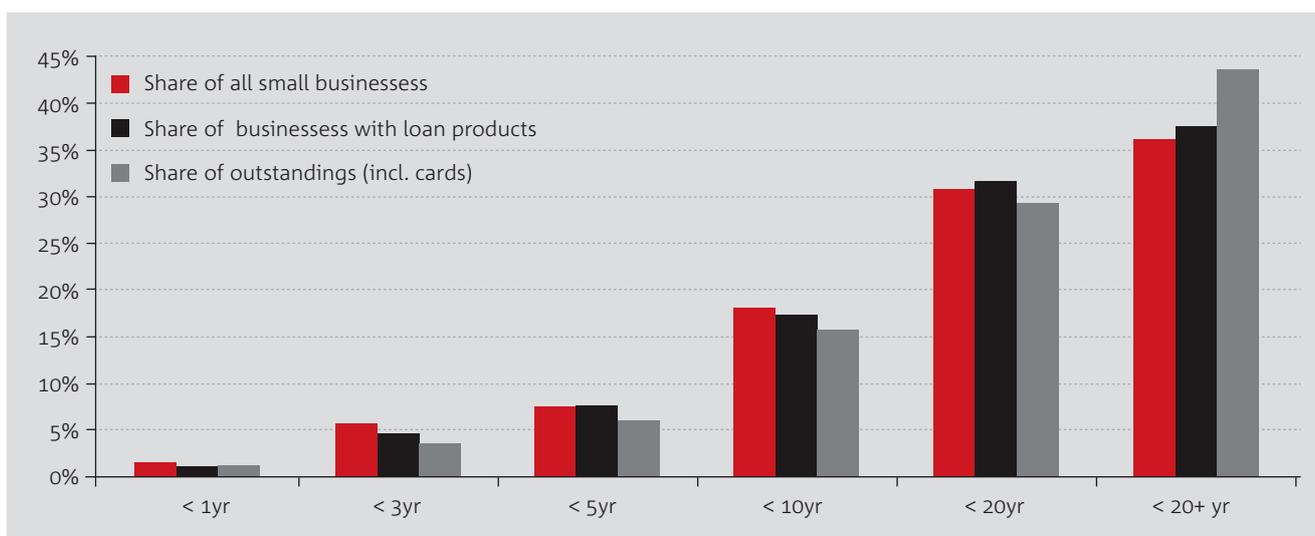
The report found that:

- Almost nine in every ten (89%) small businesses said they did not see access to finance, or the capacity to finance further growth in their business, as an 'issue'.⁵⁹ Of the remaining 11%, 7% already have a loan and 4% do not.
- Amongst the twenty major concerns raised by small businesses, access to finance rated 15th.

Further evidence from the report shows 'a [clear] trend increase in the use of lending products as the years of operation increased, from 40% for small businesses which have operated for less than one year to 54% for small businesses which had operated for 20 years or more'.⁶⁰ The result being that the distribution of lending to small businesses is largely in proportion with the distribution of years of operation of small businesses.⁶¹

By way of NAB's experience, in the year to March 2014, NAB has rejected only 3% of the 8,943 applications by small businesses for business lending of up to \$1m.⁶²

Figure 4: Percentage Small Businesses by Year of Operation



SOURCE: Small Business Access to Finance - Year to March 2013", jointly commissioned by the ABA and COSBOA.

Narrowing the gap between SME borrowers and lenders

In principle, NAB supports the Committee's intent to reduce information gaps through mechanisms such as the extension of positive credit reporting. However, while recognising the benefits of such mechanisms, it is important to understand impediments and impacts with respect to administrative, cost, privacy, and regulatory issues.

These additional costs associated with any change to the current Comprehensive Credit Reporting (CCR) regime will be difficult to determine accurately, as the current regime is not yet fully implemented.

The implementation of an SME finance database alone will not solve all information asymmetry issues, particularly for newly formed businesses, which have insufficient trading information for banks to assess a loan application. The Committee should not expect that a reduction in lending rates will automatically follow the introduction of a CCR database for SMEs.

⁵⁸ Australian Bankers' Association and Council of Small Business Associations of Australia. "Small Businesses: Access to Finance Report - Year to March 2013"

⁵⁹ Ibid. p.27.

⁶⁰ Ibid. p.22.

⁶¹ Ibid. p.23

⁶² 81.1% were accepted; 9.1% were pending a decision; 6.8% were not taken up (either the applicant accepted a competing offer for finance, or withdrew their application). Applications are for all business lending applications of less than \$1 Million processed through NAB's automated credit-decisioning tool and does not include applications for Home Lending, SMSF, Agribusiness Products or Asset Finance.

There is considerable innovation in the SME market and new business models are challenging traditional thinking and structures. For NAB to continue to lend responsibly, it is imperative that we assess every business loan on its merits. The needs of our small business customers vary greatly and we believe that a CCR database is not going to solve the core issue, but rather, a much wider range of solutions is appropriate, including, simplified and standard application forms, education and training for SMEs and better collaboration between Industry, Associations and Government.

Loan Structuring and the SME experience

It is NAB's view that covenants are about managing risk, not about restricting access to finance. Loan covenants are an important tool in structuring the loan to be a trigger to prompt proactive involvement by the banker and the client, so as to ensure positive outcomes during financial stress. Accordingly NAB does not support additional restrictions on loan covenants.

Developing securitised SME loans

NAB is supportive of the development of a domestic market for securitised SME loans, as it would allow for greater recycling of capital intensive assets. However, it is our view that, at present, there are limited prospects for the emergence of such a market. NAB has previously successfully undertaken synthetic balance sheet Collateralised Loan Obligation (CLO) transactions (in 2005 and 2006) in connection with pools of institutional loan assets, which effectively allowed the bank to securitise these assets and have the benefit of both regulatory capital relief and funding. However, these structures are not expected to be supported by the Australian securitisation regulatory framework going forward (currently under review) in a way that would make synthetic balance sheet CLOs a viable alternative for the Australian banks.

The regulatory capital relief likely to be derived via execution of an SME CLO-type transaction would depend on the ability to externally place the entire CLO capital structure and the associated costs. In the first instance, while some appetite across the capital structure may exist, it would be challenging to place all issued securities externally at a cost acceptable to the bank, so as to complete a meaningful size transaction.

From the funding perspective, as investors are likely to require Credit Linked Notes (CLNs) to be rated, there would be limited benefit to a bank in issuing an SME CLO with the proceeds of issuance being placed on deposit. The rating of the securities would be subject to the inclusion of rating agency downgrade provisions that result in the deposit having to be moved to another bank should the bank's credit rating fall below a certain level. This structural feature reduces the value of the funding to the bank from the outset of the transaction, as the bank is effectively at risk of losing the funding when it would need it most. As a result, this funding source would not be considered to be as valuable as other funding options available to the bank.

Recommendations:

- NAB supports the expansion of CCR to SME customers. However this will not automatically improve access to or costs of funding for SMEs, particularly for newly formed businesses, as CCR cannot replicate the role of the Client-Banker relationship.
- No additional restrictions should be placed on current SME loan structuring practices.
- NAB is supportive of further analysis and development of a regulatory framework that would aid in development of a domestic market for securitising SME loans.

16. Shared Value Initiatives

NAB believes that ‘shared value’ initiatives, by Government and Industry, are an important tool to service the community and to further corporate responsibility in the Financial System. Shared value is best described by Professor Michael Porter:⁶³

“Shared value creation focuses on identifying and expanding the connections between societal and economic progress.”

NABs current focus is on two primary initiatives: 1) Impact Investment and 2) Micro-financing.

Impact Investment and social impact bonds

Global trends and market forces, such as an ageing population and a declining tax base, support the forecast that ‘impact investment’ will be a \$32bn market in Australia by 2022.⁶⁴

As a bank, we believe we have a responsibility to deliver innovative financial solutions that help our customers address social and environmental problems through impact investment. Supporting impact investment makes commercial sense and is aligned with NAB’s values of building prosperous communities.

Although we are only just starting to understand our role within this nascent market, we have made a commitment to actively support the development of the Australian market through:

- 1) Supporting customers who are looking to develop businesses with impact or facilitate investment.
- 2) Participating in the Australian Advisory Board which is contributing to the G8 Taskforce Australian Sector report designed to foster the growth of impact investment (to be released on 15 September 2014).
- 3) Contributing to research, JB Were co-authored IMPACT-Australia and contributed to Place-based impact investment in Australia.
- 4) Working with the organisations leading the change, such as *Impact Investing Australia*, *The Difference Incubator* and *The Centre for Social Impact*.

NAB actively develops and promotes social procurement. Our view is that every dollar spent can have positive social impact on our communities. In the same way, Government procurement is also of a scale sufficient to foster growth of the impact investment market. It can allow the not-for-profit sector to contribute to improving social (and environmental) outcomes through ‘payment by outcome’ contracts or Social Impact Bonds. Leveraging global best practice for social impact bonds will increase the speed-to-market and scale of these products.

Governments in other countries have shown how timely action can encourage the growth of impact investment.⁶⁵ NAB supports actions that would drive market development in Australia, including:

- Closing the gap between investor needs and supply of investable social enterprises, by creating a contract and investment readiness fund, to build capacity;
- Supporting intermediary organisations which can bridge this gap;
- Providing unit cost data for public consumption that can assist with benchmarking and measurement of impact investments, and;
- Establishing clear policies around impact investment, to encourage participation and attract multi-sector talent and leadership.

NAB supports a review of Government policy designed to stimulate impact investing, including exemptions to private ancillary funds and other recommendations made by the Productivity Commission⁶⁶ and the Senate Economics References Committee,⁶⁷ including:

- potential to invest a percentage of their corpus into impact investment;
- development of social investment funds to attract institutional investors, and;
- harmonise tax concessional status definitions at the Commonwealth level.

Impact investment provides an opportunity for a collaborative approach to addressing the significant growing social issues facing the Australian population. The gap between demand for welfare services and what government can provide is growing⁶⁸ and we believe that making no change to the current arrangement would disadvantage the Australian economy in the future.

63 Porter, M. and Kramer, M., “Creating Shared Value”, Harvard Business Review, January 2011, <http://hbr.org/2011/01/the-big-idea-creating-shared-value>

64 Addis, R., McLeod, J. and Raine, A., ‘IMPACT-Australia: Investment for social and economic benefit’, March 2013.

65 Ibid.

66 Productivity Commission, “Contribution of the Not-for-profit Sector”, Canberra 2010

67 Senate Economics References Committee, ‘Investing for good: the development of a capital market for the not-for-profit sector in Australia’, Committee Hansard 2011.

68 Addis, R., McLeod, J. and Raine, A., ‘IMPACT-Australia: Investment for social and economic benefit’, March 2013.

The importance of microfinance in Australia:

Microfinance initiatives that address financial exclusion have a clear social impact, but there is also a strong economic case through greater workforce participation and reduced welfare and health costs.

Research into the social and economic impact of microfinance in Australia validates the need to ensure these programs are available to people on low incomes:

- For every dollar invested in the No Interest Loans Scheme (NILS) and StepUP Loan Program, between \$1.59 and \$2.68 of social and economic benefit is generated.
- Of those surveyed, 82% of NILS recipients and 73.6% of StepUP loan recipients reported a net improvement in social and economic outcomes.⁶⁹

The role of public and private partnerships in microfinance

There is a need for a variety of microfinance products and programs, given the difficulty in reaching people who are financially excluded through traditional banking channels.

The current partnerships between NAB, the Commonwealth and State Governments, Good Shepherd Microfinance and other community organisations has unlocked capital that would otherwise have been unavailable to those on low incomes.

In particular, the Federal Government injection of \$18.5m to Good Shepherd Microfinance and NAB's partnership in 2009⁷⁰ saw the NILS program grow from having provided only \$3.2m in loans in 2009 to more than \$62m by 2014. Without government support, it would not have been possible to achieve this scale in such a short time.

There is a need for further Government investment in microfinance programs. It is estimated that the current capacity of NILS is only meeting 6.1% of the estimated demand.⁷¹

The not for profit sector delivering community finance requires a policy and funding environment that supports the delivery of high quality services to the people who need it most. Evidence has shown that those who received support services (such as financial counselling) together with a NILS loan were more likely to experience an increase in financial capabilities and positive economic, and social and health outcomes.⁷²

Long term funding commitments of five years or more allow for the protection of the capital investment into these programs, the exploration of innovative alternatives and also support greater capability in the sector.

Recommendations:

- Government should take an active role in establishing a market for financial products in Australia to support impact investment, including Social Impact Bonds and support for intermediary institutions and organisations that can act as a catalyst for the market's development.
- Fiduciary duties for trustees should be clarified, so that trustees are able to consider Impact Investment as part of their investment portfolio.⁷³
- Government should consider expanding its current level of support for Australia's microfinance sector, as it has proven to be effective at leveraging community and private sector capabilities.
- A long term funding commitment of five years or more is required to allow for the protection of the capital investment into these programs and the ongoing exploration of innovative solutions to enable scale and reach.
- NAB does not support the enforcement or regulation of mandatory programs at an industry level. We believe this will lead to broad brush and sub-standard solutions that will have little impact.

69 Bennett, S. Georgouras, M. Hems, L. Marjolin, A. and Wong, J. "Life Changing Loans at No Interest: An Outcomes Evaluation of Good Shepherd Microfinance's No Interest Loans Scheme (NILS)", Centre for Social Impact (CSI), University of New South Wales, for Good Shepherd Microfinance and Centre for Social Impact "A little help goes a long way: Measuring the impact of the StepUP Loan program", Centre for Social Impact (CSI) - University of New South Wales.

70 NAB, "NAB thanks Government for microfinance support", <http://www.nab.com.au/about-us/media/media-releases-2009/nab-thanks-government-for-microfinance-support>, 2009.

71 Bennett, S. Georgouras, M. Hems, L. Marjolin, A. and Wong, J. "Life Changing Loans at No Interest: An Outcomes Evaluation of Good Shepherd Microfinance's No Interest Loans Scheme (NILS)", Centre for Social Impact (CSI), University of New South Wales, for Good Shepherd Microfinance, p.37.

72 Ibid.

73 Charlton, D., Scott, D., Orminston, J. and Seymour, R., "Impact Investment: Perspectives for Australian Superannuation Funds", October 2013.

17. Concluding Remarks

Australia's current financial system has proven itself to be without peer. The stresses of the GFC were handled in a way that resulted in confidence in the system being maintained and the impact on the real economy and sovereign balance sheet being kept to a minimum. This was unlike the experience of most other developed nations. Changes to the financial system must ensure that these benefits are maintained, whilst also ensuring that the system is equipped to deal with the challenges and opportunities ahead.

We have welcomed the opportunity to make a second round submission to the Inquiry and we would be available to expand upon the content of this document at the request of the panel.

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